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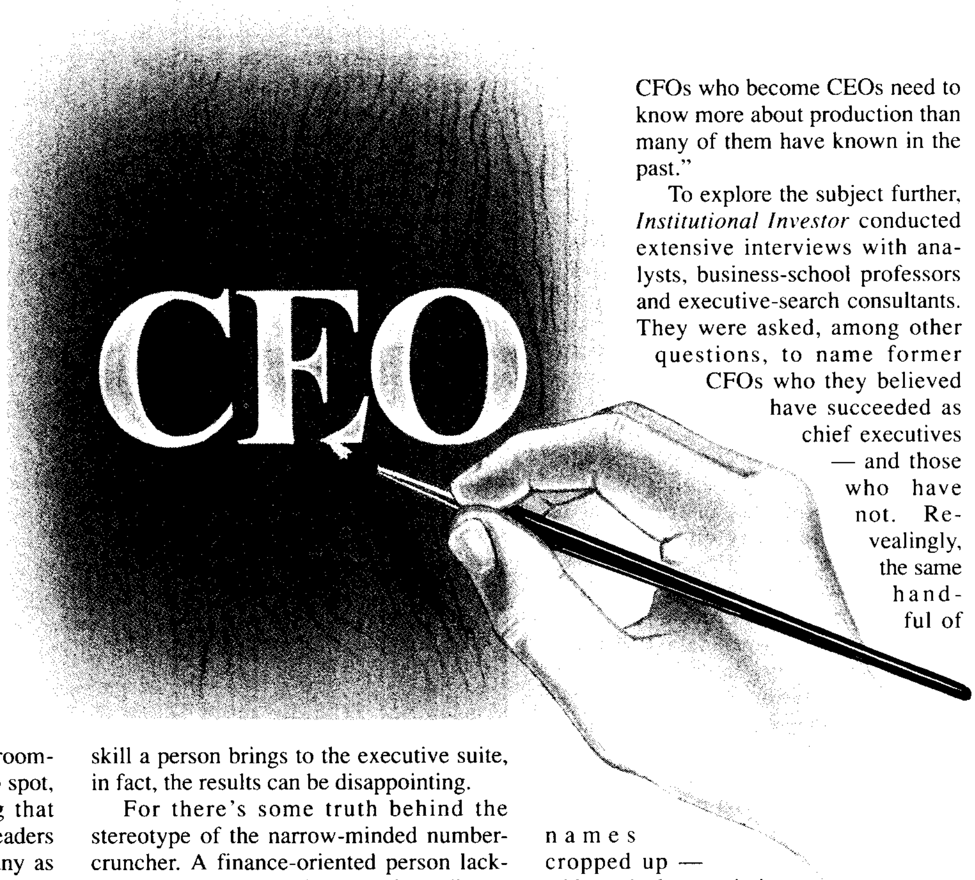
Do CFOs really make good CEOs?

More and more top executives are being drawn from the ranks of finance. Analysts say this has pros — and cons.

BY IDA PICKER



When D. Wayne Calloway took over as president at PepsiCo in January 1985, the company's cash flows had dwindled to the point where it practically had to borrow money to pay dividends. Calloway rolled up his plaid shirt sleeves and orchestrated a major restructuring. Four years later analysts are gushing about Calloway and Pepsi's soaring profits.

Calloway, who became chief executive in May 1986, was formerly PepsiCo's CFO. Is there a lesson here?

These days, with corporate America roiled almost constantly by takeovers, leveraged buyouts and restructurings, it would seem that chief financial officers hold the keys to executive wisdom. And in fact, quite a few people applaud the perked-up status of what was once the lowly bean counter. Recruiters report a growing trend of grooming chief financial officers for the top spot, with some headhunters estimating that nearly 25 percent of top corporate leaders are former CFOs, about twice as many as in 1960. "In a lot of companies we recruit for, they want a CFO who could be the CEO," says George Wilbanks, an associate at Russell Reynolds Associates, an executive-search firm.

Some industries, such as airlines, began looking to financial experts for leadership with the onset of deregulation. And troubled companies in other fields often ask recruiters to find a financial type from outside to step into the CEO spot and turn the place around. But though a competent chief executive must have an understanding of numbers, that doesn't mean that an understanding of numbers is *all* it takes to make a good CEO. If finance is the only skill a person brings to the executive suite, in fact, the results can be disappointing.

For there's some truth behind the stereotype of the narrow-minded number-cruncher. A finance-oriented person lacking "real-world operating experience," suggests one analyst, may be "more concerned with romancing numbers than romancing operations. He may produce results on paper but somehow never actually realize them." A Massachusetts Institute of Technology commission on industrial productivity concluded this spring that "the U.S. is misguided at its corporate core," largely because many managers lack an understanding of their company's basic operations. And as for the growing prominence of former CFOs in the country's executive suites, MIT Professor Robert Solow, a Nobel laureate in economics and the commission's vice chairman, says, "We do think CFOs who become CEOs need to know more about production than many of them have known in the past."

To explore the subject further, *Institutional Investor* conducted extensive interviews with analysts, business-school professors and executive-search consultants. They were asked, among other questions, to name former CFOs who they believed have succeeded as chief executives — and those who have not. Revealingly, the same handful of names cropped up — with particular unanimity in the case of CFOs who observers felt had not made the transition successfully.

Not surprisingly, analysts, academics and headhunters agree that the ideal CEO communicates well, is adept at managing his managers, understands the company's product and operations and provides a consistent vision. The best CEOs have honed their managerial skills in an operational post before taking on the big job, says consultant Lowell Bryan of McKinsey & Co. They also have a "really good intuition for people [that enables them to] match the skills of

Robert Pasternak

individuals with the company's needs," Bryan adds. "You end up describing Superman."

Those former CFOs who have excelled as chief executives have done so because they broadened themselves beyond their financial backgrounds and could relate well to people. Executive recruiter Emanuel Monogenis of Heidrick and Struggles observes: "When I do a CEO search, companies are asking for someone who has the emotional stability to deal with a broad range of issues and personalities. Included in that is leadership and vision. They don't teach you that at Harvard." A look at ex-CFOs who have fared less well at the top points up what Harvard Business School professor Robert Hayes suggests are the drawbacks of trying "to solve problems by buying solutions" — which is "a natural reaction to dealing with the market" — as finance officers are trained to do.

But as part of a spectrum of skills, financial dexterity obviously helps the CEO do his job. Today, three years after Calloway took over as CEO at PepsiCo, the company is expected to generate close to $500 million in surplus cash *after* paying dividends, says Joanna Scharf, a Drexel Burnham Lambert analyst. In her view Calloway pulled off this feat by figuring out how to get the most out of the company's assets with the least amount of capital. For example, after buying Kentucky Fried Chicken, he extended the menu beyond dinner to include lunch and snacks so that customers would be lured in at other times of the day. At the Pizza Hut subsidiary, he launched a delivery business, which could be opened at a small fraction of the cost of a full-service restaurant.

Calloway was also instrumental in focusing the company on snack foods and restaurants and getting rid of several non-core, low-profit businesses, such as North American Van Lines and Wilson Sporting Goods, says analyst William Leach of Donaldson, Lufkin & Jenrette. That such operational decisions come naturally is a tribute to Calloway's tenure running subsidiary Frito-Lay from 1976 to 1983.

Yet Calloway credits his year-and-a-half tour as CFO with having given him a framework within which to promote teamwork. "Financial performance is the one piece that helps you see the overall picture," he says, since this is the one area in which every aspect of the company is reflected. The less tangible elements of his approach include "picking the right people for the team" and creating the right environment for people to thrive in. With his informal style — he has a habit of plopping down in an employee's office and asking, "How are things going?" — he creates "a kind of Miss America atmosphere where people want to be the best they can possibly be," says PaineWebber analyst Emanuel Goldman. Calloway himself puts it a little differently: "We've tried to be the biggest little company anybody ever saw," with the spirit of a small entrepreneurial company.

Calloway considers finance only one of several alternative desirable backgrounds for CEOs. But there are certain industries in which it has been downright essential lately. There was a time when a simple operations background seemed adequate for airline executives, for example, but increased competition engendered by deregulation created a demand for marketing and planning expertise. Helter-skelter postderegulation overexpansion led some airlines into a financial quagmire, and the industry decided that paying more attention to the bottom line might be a good idea.

Sure enough, finance and marketing turned into executive spawning grounds. The heads of Pan Am Corp., Northwest Airlines and American Airlines are all former CFOs, operating with widely varying degrees of success. American, of course, has been the most profitable of all U.S. airlines for the past few years, thanks to the vision of CEO Robert Crandall.

Clearly, Crandall's finance training provided him with the cost-consciousness to bring expenses into line. But Drexel analyst Michael Derchin attributes Crandall's success to "tying all the disciplines together" — cost structure, marketing and labor relations. Luckily, Crandall was also well versed in data processing. Given his double-barreled background, Crandall could recognize the huge volume of business that deregulation would stimulate. As head of marketing in the mid-1970s (in addition to his CFO duties), he was one of the first to develop computerized reservation systems.

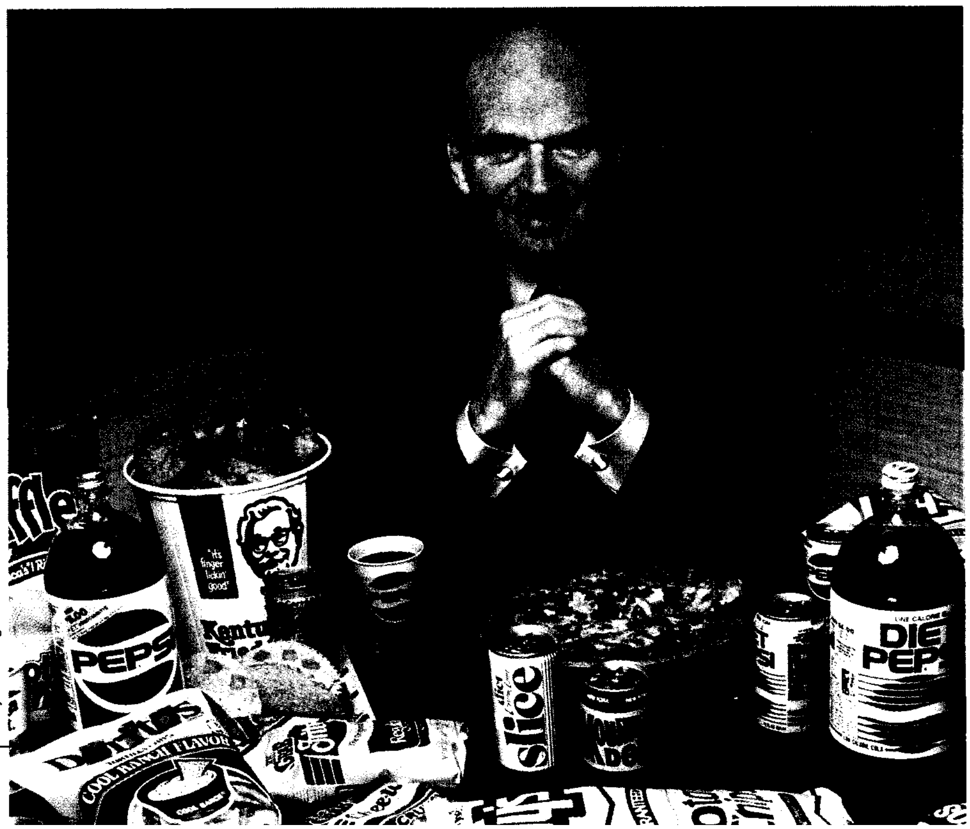
After becoming president in 1980 (and CEO in 1985), Crandall was able to come to grips with American's gargantuan cost structure without antagonizing labor; in 1983 he convinced unions of the need to institute market-rate pay. Essentially, this means that new employees start at the same pay level as those in comparable positions in other industries, considerably lower than traditional union entry rates. The resulting reduction in overall labor costs was dramatic.

Shearson Lehman Hutton analyst Helane Becker considers Crandall's grasp of finance central to his success in "orienting the entire company towards profits." Also, she adds, like most good CEOs, he can look beyond the numbers and plan ahead. For example, five years ago he ordered more equipment for American, anticipating a need a few years later. At that time, during the recession, "when no one else wanted the planes," Crandall could buy them almost for a song.

Keep on truckin'

Navistar International Corp. chief James Cotting can also see the world by the numbers. But he's up to his elbows in nitty-gritty stuff like paint, plastic and foundries as well. Analysts respect Cotting for taking a company "wracked with losses and the dismemberment of the agricultural division" in the early 1980s and refocusing it on what it does best — build trucks — according to analyst Richard Henderson of DLJ's Pershing unit. Navistar is now the No. 1 manufacturer of medium- and

Experience in both finance and operations explains much of former CFO **D. Wayne Calloway***'s success as PepsiCo's chief executive, say observers*



Andy Freeberg


Photoreporters

Analysts suggest that his financial background causes General Motors CEO* Roger Smith *to look at problems in narrowly numerical terms

heavy-duty trucks in North America, with a 27 percent market share, and ranks first worldwide in the production of medium-duty diesel truck engines.

In 1985, after selling the agricultural business (and the name International Harvester, as Navistar was then known) to Tenneco, CFO Cotting reduced the company's debt dramatically and built a respectable balance sheet through a series of restructurings. His finance background was "clearly a plus" in bargaining with financial institutions at these debt negotiations, notes Fitch Investors Service's Mary Anne Sudol. His skill at number-crunching continued to come into play after the first reorganization, as he developed a strong cash flow, built up a cash hoard of close to $600 million and positioned the company for an acquisition.

Yet, since becoming CEO in 1987, Cotting has also acted against the instincts inherent in his background (he was CFO at International Paper Co. before joining International Harvester in 1979) by taking near-term hits to bring about basic improvements in the quality of the company's trucks. He is investing in long-term quality, Pershing's Henderson notes, by plowing money into a "world-class paint facility," improving his foundry, expanding the plastic-making operations and investing in research and engineering.

Self-education

The secret to Cotting's success? Gathering knowledge of all aspects of the company during his ten years at IH/Navistar, though this rigorous self-education was not strictly part of the CFO's job description. "I always feel you need to be able to understand issues right down to bedrock to have a broader perspective," Cotting says. So he continues to make time to visit the company's managers at its various plants, as well as its customers. And when Cotting presides at analyst meetings, he can answer specific questions about production and manufacturing without deferring to line managers, as many CEOs do.

But not every CFO-turned-CEO has made the passage smoothly or with consistently stellar reviews. In some cases, industry analysts contend, a financial background has hindered rather than helped. For example, auto analysts often criticize General Motors' tradition of moving finance types into the company's driver seat. "At GM, coming out of the finance department is a negative," in the view of Montgomery Securities analyst Ronald Glantz. Basically, it means that "costs and/or returns have tended to dominate product decisions," says Shearson analyst Joseph Philippi.

Conceding that GM CEO Roger Smith is "brilliant" and much more sensitive to market conditions and trouble within the company than some of his predecessors, one analyst nonetheless says that the former CFO tends to look at problems in numerical terms without seeing the wider ramifications. For example, in the early 1980s, when GM saw high hourly wages as a key problem, Smith spent a bundle on automation. "That prevented the company from addressing the really basic problems," in one analyst's opinion, such as declining quality and lack of simplicity in overall car design, "which were far more complex than hourly wages." This kind of bottom-line tunnel vision, the analyst asserts, also prevented the company from realizing that "real cost savings come out of higher quality."

Smith's embrace of automation also included the purchases of Hughes Aircraft Co. and Electronic Data Systems Corp. Both would ultimately prove disappointing, because Smith's high tech was not the panacea for GM's steadily declining market share and because the mergers themselves were so messy. Smith is "not a people person," according to Montgomery's Glantz. In the case of EDS — an alliance that was to bring together all GM's software and management-information and telecommunications systems into a cohesive, global unit — "he did not understand what he had to do to prepare GM people," according to Glantz. "He never convinced people their jobs were safe." On the contrary, Smith would make public announcements about automating to get rid of workers.

As for the notion that spending $5.5 billion for Hughes Aircraft would create better cars for GM, many analysts remain to be convinced. The two most tangible automotive projects so far have been collision-avoidance radar systems and "head-up displays," which float a digital readout of the speedometer so the driver needn't look down. "This is very exotic stuff," says Shearson's Philippi. "If you need things like that, you rent them." Ditto, he adds, for the expensive goodies acquired through the purchase of EDS, where enormous cultural differences called for especially careful handling of the integration with GM. EDS president H. Ross Perot's virtual declaration of war against Smith and the carmaker suggests this is not what happened.

Finally, says Philippi, "You have to really like the product. I don't think I'd ever characterize Smith as a car nut." Several analysts point to a period when GM didn't differentiate enough between models ostensibly designed to appeal to different buyers. The problem, explains Glantz, is that "it's hard to tell a finance guy, 'I want a couple bucks because I want the door to sound like *this* when it closes.' "

Misunderstood

Smith has little patience for his detractors, who he suggests don't understand what a CEO — or a CFO, for that matter — does for a living. Design details such as door handles? "Bean counters don't make decisions on door handles," Smith says. "Stylists do that. I don't make decisions on door handles." He doesn't dispute the notion that a CEO should have an interest in the basic product his company produces. But he also thinks that owning a bright yellow 1936 Cadillac sedan, a bright red 1960 Corvette, a 1964 Corvair convertible ("I like convertibles") and a 1967 Corvette certainly qualifies him as a car person.

Smith turns another analyst criticism on its head. "Finance," he argues, "*does* lead you toward longer-term thinking," and he considers his purchases of Hughes and EDS consistent with his vision of "making GM the world's premier auto corporation."

In this context, Smith is particularly enthusiastic about the Hughes merger, asserting that the 26,000 engineers that were part of the package will be a "precious commodity" in the future. And far from being esoteric options, Smith says he expects things now being developed by his high-tech army, like antiskid brakes, eventually to become standard equipment. Critics of his high-tech projects, Smith quips, "sound like the guys standing next to Queen Isabella, telling her, 'For cripes'

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sakes, don't give Columbus any money for the ships.' " (And the ex-CFO also can't help noting that "the market value [of Hughes and EDS] is now over twice what we paid for them.")

Edward Hennessy Jr., CEO at aerospace, automotive-products and engineered-materials conglomerate Allied-Signal, has come under similar fire — for a tendency to buy solutions and a failure to get beyond the numbers. In addition to Allied's involvement in the tumultuous 1983 takeover battle between Bendix Corp. and Martin Marietta Corp., resulting in Allied buying Bendix for $1.8 billion, Hennessy acquired Signal Cos. two years later, in a stock swap valued at between $4 billion and $5 billion.

Harvard's Hayes, for one, accuses Hennessy of too much restructuring and not enough internal changes. "I think his solution is to say, 'Okay, let's buy managers, buy market share and, if we need technology, buy technology.' He misses the fact that some things are difficult to buy."

Despite his CFO credentials, a number of analysts even question Hennessy's financial acumen. "I don't think he has a good sense for value, a good sense for numbers or a good sense for investing," says one of them, referring specifically to the company's acquisitions. (Analysts by and large prefer to keep their comments about Hennessy off the record; they allege that the company is already difficult enough to follow without making things worse by unnecessarily aggravating the CEO.)

Some observers remain puzzled by Hennessy's stock swap with Signal, in which Signal stockholders came away with 40 percent ownership in the combined Allied-Signal entity. "He gave up way too much, diluted the value of Allied shareholders' stock," in the opinion of another analyst, "and the company has been paying the price for the last three years." Moreover, Harvard's Hayes points to the disappointing performance of the postmerger company, which, he suggests, "doesn't appear to be any better than the collection of the parts."

Others criticize Hennessy's frequent changes in strategy. For example, at the end of 1986, Allied announced a major push into defense electronics, a strategy Hennessy reaffirmed adamantly late in October 1987, despite the crash. A week and a half later, he reversed himself, stating that the company would retrench and *not* go into defense systems because it needed a better balance between long-term growth and current earnings. The company took a similar on-again/off-again approach to the health care business in the early 1980s. An analyst recalls that, with Allied in such a state of flux through 1985, his firm stopped running a book list of the company's acquisitions since so many of them kept showing up on the list of divestitures on the following page.

When pressed, however, even Hennessy's detractors will admit that he has built a stronger company than the one that existed in 1977, with three very solid core businesses. It's a theme sounded by Hennessy himself, who emphasizes that "through a great deal of effort and money" Allied has grown from a $3 billion commodities chemical company, "with little to differentiate it from its competitors and poor prospects for the future," to a $12 billion advanced-technology operation.

He also questions whether securities analysts are the best judges of a company — or its CEO. Criticism from the financial community these days, he notes, is all too familiar, and is "based on one simple, widely acknowledged fact: Because of its interest in short-term performance, Wall Street doesn't give companies like Allied-Signal credit for doing the things necessary to remain strong competitors in a tough, worldwide marketplace." And citing Allied's improved second-quarter 1989 results, Hennessy concludes, "Our strategy is paying off."

Significantly, perhaps, a number of analysts have unqualified praise for Hennessy's recent promotion of Alan Belzer from president of Allied's engineered-materials group to company president. Belzer, who has a solid operations background in addition to expertise in finance and accounting, is credited by one stock-watcher with taking a "pretty ragbag chemical company and turning it into a big profit contributor."

Harbinger

Sound familiar? Those former CFOs who have made the transition to chief executive most successfully — PepsiCo's Calloway, American Airlines' Crandall and Navistar's Cotting — have immersed themselves in both finance and operations.

Indeed, this may be a harbinger of things to come. A recent survey by *Management Practices Quarterly* reveals that of 83 new chief executive officers appointed last year, more than 18 percent of them came from operations/production backgrounds; some 23 percent had technical training, while only 14.4 percent had a financial background — almost exactly the same percentage that came from the legal profession. These days, the publication concluded, CEO selections are "increasingly made on the assumption that finance is a more easily learned skill than science or engineering." ♜